

Sellers of special order machines are considered to be engaged primarily in a service occupation, rather than being engaged in the business of selling tangible personal property, if the test set out in 86 Ill. Adm. Code 130.2115(b)(1) is met. See 86 Ill. Adm. Code 130.2115. (This is a PLR.)

October 16, 2006

Dear Xxxxx:

This letter is in response to your letter dated January 30, 2006, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.1120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

This letter is a request for a Private Letter Ruling (PLR) under 2 Ill. Admin. Code Sec. 1200.110. The PLR is to address the expansion of a specially-designed automated storage and retrieval system with the addition of 3 cranes and expanded racking systems in 4 bays ('Additional Conveyors') purchased by COMPANY. In the previously reference [sic] PLR dated August 25, 2003, the Illinois Department of Revenue ruled that the purchase of the original system ('Conveyors') is a purchase of a special order conveyor system under the guidelines of subsection (b) of Section 130.2115 based on the facts contained within the original request for a PLR (see attached).

FACTS

COMPANY is a distributor of steel products. To streamline its inventory operations and achieve cost efficiencies, it contracted with an independent company ('Seller') to design and install four specially-designed and automated conveyors for use at its CITY, Illinois distribution facility ('Warehouse'). COMPANY used the Conveyors to account for and hold inventory. The conveyors fulfill customers' orders by retrieving inventory and

packaging products for delivery. The Conveyors are operated entirely through a computer system which the Seller has also provided to COMPANY. COMPANY originally had two of the conveyors engineered to conform to the particular size and shape of its existing warehouse. When COMPANY had a contractor build an addition onto the warehouse, it ordered from the Seller two additional conveyors. These conveyors were then designed and engineered to conform to the particular size and shape of the new addition.

To meet all the aforementioned requirements, COMPANY chose the Seller over other businesses because of the Seller's website and its other promotional materials indicated that it considers itself an internationally-known market leader in engineering, designing, and manufacturing material-handling systems for meeting its customers' specific needs.

The originally constructed conveyors were erected in sections of the warehouse known as bays. In designing and fabricating the Conveyors, the Seller performed time-study simulations for determining their most efficient placement within each bay. The Seller performed the simulations using Company-supplied data relative to variances in its current and potential inventory levels, products' weights, shapes, and sizes, picks per hour, and storage and delivery requirements. The Seller's computer programs then generated layouts and designs specifically tailored to meet COMPANY's current and future product-flow needs for each of the bays.

The engineering of the conveyors also required that the Seller conduct numerous tests of the warehouse's foundation and flooring to ensure that the ground underneath the conveyors remain level. The results of these tests and aforementioned simulations—which included an eight-week analysis in Germany (where the Seller is based) and another eight-week study in the United States—allowed the Seller to design the conveyors to the precise specifications and needs of COMPANY.

The Seller's 371-page PUBLICATION and approximately 8-120 blueprints evidence the Seller's substantial contribution to the detailed configuration of the conveyors. The design, engineering, fabrication, and installation of the conveyors required that the Seller create for each of the bays between twenty and thirty blueprints outlining their composite layout. The blue prints illustrate the conveyors' floor and ceiling supports - - including their angles and elevations – and the placement of their laser eyes, cassettes, audible fault alarms, rail cranes, energy supplies, shelf blocks, protective fences, maintenance doors, carrousel stations, weighing and lifting devices, and automatic bundlers, all of which conform to the unique floor place of COMPANY's warehouse. The blueprints also convey many precise details which allow the conveyors to conform to the warehouse's structural configuration - - namely, cassette lengths and positionings to accommodate different types of products to be stored and transported, distances between doors, locations of various laser eyes, speeds, lengths, ascents, and descents of belts placed at specific points, high voltage rails and their power supplies, and the location of feeder and takeaway lines.

The Seller will design the Additional Conveyors according the specifications derived from their simulations and studies performed during the construction of the original Conveyors described above. In addition, the design specifications and blueprints created during the original purchase will be the basis for the fabrication of the Additional Conveyors.

According to COMPANY, the Seller's original costs incurred for the design and engineering services, fabrication labor, and installation represent approximately 85-90 percent of the conveyors [sic] purchase price to COMPANY, while direct material costs represent approximately 10-15 percent. The Seller relied on the design and engineer services of the original purchase of conveyors. The additional design, engineering services, fabrication, and installation required for the Additional Conveyors represent approximately 80-85 percent of the Additional Conveyors [sic] purchase price, while the directly [sic] material costs represent approximately 15-20 percent. The Seller is not registered as an Illinois retailer, since it makes no retail sales. Rather, the Seller is considered a service provider (serviceperson), as its line of business focuses upon providing engineering and design services to its customers. Further, less than 35 percent of its overall revenue represents its cost of goods sold (i.e.. direct materials costs) to its service customers.

The Additional Conveyors' structural design features demonstrate that they are not permanently affixed to the warehouse. In other words, they rest upon leg supports standing approximately three feet off the ground. The legs are connected in turn to base-plate anchors with holes drilled in them. The anchors are approximately six to eight inches in length. Bolts, screwed into anchors' holes, are then used to secure the conveyor systems to the floor of the bays. The Additional Conveyors may be removed with no damage to the underlying realty as long as the bolts are unfastened and the anchors pulled out. Indeed, COMPANY's approval of the aforementioned designed features evidences its own intention that the Additional Conveyors not be considered part of the underlying realty.

It is possible, therefore, that the Additional Conveyors could be dismantled and erected at another warehouse. Practically speaking, however, it would be prohibitively expensive to do so, since another set up would require the entire redesign and reengineering of the conveyors and a series of foundation tests to ensure their stable positioning. In other words, any potential buyer of the conveyors would need to have precisely the same order flow, customer base, warehouse layout, floor plan, production requirements, and a myriad of other identical business concerns in order for COMPANY's conveyors to have any value for it. In fact, COMPANY's conveyors would not even be useful at COMPANY's other warehouses (all located outside Illinois) due to differences in their layout, product flow, and customer requirements. No other business would purchase COMPANY's conveyors, as it would simply be less expensive and more practical logistically to contract for its own specially-ordered conveyors.

ISSUE

How should COMPANY treat the additional conveyors for Illinois sales and use tax purposes?

STATEMENT

COMPANY is not under audit by the IDOR. IDOR has previously ruled on the substantially similar issue of the original purchase contract with COMPANY (see attached ruling).

LAW

Illinois imposes a Retailers' Occupation Tax (the ROT) at a rate of 6.25 percent on persons engaged in selling at retail within the state tangible personal property.¹ A Use Tax (the UT) at a rate of 6.25 percent is imposed upon the privilege of using in the state tangible personal property purchased anywhere at retail.² Illinois also imposes a Service Occupation Tax (the SOT) at a rate of 6.25 percent on tangible personal property which servicepersons transfer as an incident to making sales of service in the state.³

When a serviceperson designs, develops, and produces special-order machinery or equipment, taxation under the SOT Act applies and it [sic] measured by the cost prices to the serviceperson of the tangible personal property transferred to the services customer.⁴ 'Cost price' means the consideration that the serviceperson pays to its supplies [sic] for the tangible personal property that it transfers to its service customer.⁵

Pursuant to an IDOR regulation, special-order machinery is produced when (1) the purchaser employs the seller specifically for its engineering and design skills to produce a machine to meet the purchaser's particular and unique needs; (2) the machine has use or value only for the specific purpose for which it is produced; and (3) the machine has use or value only to the purchaser. The regulation adds that, in the case of special conveyors, the sale would receive SOT treatment even if a fairly substantial portion of the conveyor were made of standard parts or raw material (such as steel), which could be stocked for sale.⁶

Illinois case law addressing conveyors also stipulated three criteria for identifying special-order property subject to treatment under the SOT Act: (1) The seller contributes substantially to the design of the product; (2) The property has use or value only to the purchaser. In other words, the property has to be produced according to special requirements peculiar to the purchaser and not common to others whose conditions for possible use of the property are reasonably comparable to those of the purchaser; (3) The equipment has only salvage value to others and therefore is useless to anyone by the customer for whom it is produced.⁷

Under the SOT Act, if a serviceperson's ratio of its cost price of tangible personal property transferred to its gross receipts from services sales is below 35 percent, the serviceperson is considered de minimis. A de minimis serviceperson, who is otherwise required to be registered as a retailer, may elect to incur SOT on its cost price of the tangible personal property transferred as an incident to its sales of service. Conversely, a de minimis serviceperson, not required to be registered as a retailer, may elect to incur UT liability on the cost price to it of the tangible personal property which it transfers to service customers as incidental to making sales of service. The de minimis serviceperson incurring UT liability is considered to be the end user of the tangible personal property transferred to its service customers. However, the de minimis serviceperson may collect from the customer 'reimbursement' for its own tax liability. If reimbursement is sought and appears as a separate item on the serviceperson's bill, it must clearly be identified as 'reimbursement' for the serviceperson's UT liability and not as a tax upon the service customer.⁸

ANALYSIS

COMPANY's Additional Conveyors meet the requirements under Illinois law for designation as special-order property:

- COMPANY chose the Seller over other business competitors because of the Seller's reputation in the industry as a 'world-wide leader' in the field of designing and engineering conveyors to meet a customer's specific needs.
- The Seller's development of an extensive proposal/design plan - - including approximately 80-120 engineering blueprints - - and its performance of extensive testing and simulations demonstrate that it created additional conveyors to fit the rigorously exact and unique specifications required by COMPANY at its specific warehouse location.
- The Additional Conveyors have value only to COMPANY. Even if the Additional Conveyors were dismantled and set up elsewhere, the cost so incurred would exceed those attached to purchasing new conveyors. As such, the Additional Conveyors have little more than scrap value to any other potential purchaser.
- The Additional Conveyors remain tangible personal property after their installation. As they have been only bolted down to the underlying realty, they may be removed without damaging the warehouse. Further, COMPANY's approval of the Seller's design plan evidences its intention to maintain the conveyors upon their installation as tangible personal property.

Thus, applying state law to the facts in the case, COMPANY's purchase of Additional Conveyors should be considered special-order machinery, as was the original purchase of Conveyors.

Under the SOT Act the Seller is considered for the following reasons to be a de minimis salesperson which is not otherwise required to be registered as a retailer in the state:

- The Seller is in the business of designing and engineering special-order property, not in making sales at retail.
- The overall cost to it of direct materials used equals less than 35 percent of its overall revenues from making sales and design and engineering services.

Thus, applying state law to the facts in the case, the Seller may incur use tax measured by the cost price to it of the tangible personal property (i.e., the direct materials) transferred to COMPANY as incidental to providing COMPANY with the special-order Additional Conveyors. The use tax should be calculated by multiplying the direct materials costs by the state use tax rate of 6.25 percent. COMPANY as the customer of the de minimis serviceperson, should not incur any tax liability in this regard.

INFORMATION TO BE WITHHELD

We respectfully request that the IDOR delete COMPANY's name from the publicly disseminated version of the PLR.

CONCLUSION

Based on the foregoing analysis please confirm that:

- COMPANY's purchase of Additional Conveyors should be taxed under the SOT Act and be measured by the Seller's cost price of the direct materials transferred to COMPANY.
- The Seller, as a de minimis serviceperson not otherwise required to be registered as a retailer in the state, should incur tax measured by the cost price to it of the

direct materials transferred to COMPANY. The use tax should be calculated by multiplying the direct materials cost by the state use tax rate of 6.25 percent.

- As COMPANY is not considered for state law and IDOR regulatory purposes, the user of the materials conveyed, it should incur no tax liability in this transaction.

We respectfully request that the IDOR send to us on behalf of COMPANY a PLR addressing the issue presented. We appreciate your response to this matter.

DEPARTMENT'S RESPONSE

Based upon the information contained in your letter and the documents you have provided, we believe that COMPANY's purchase of the conveyor system described in your letter and the Outline Contract is a purchase of a special order conveyor system under the guidelines of subsection (b) of Section 130.2115. Consistent with the Illinois Supreme Court's decision in Velten & Pulver, Inc. v. Department of Revenue, 29 Ill. 2d 524 (1963), the sale of this special order conveyor system is not considered a sale at retail and is subject to tax under the Service Occupation Tax Act and the Service Use Tax Act rather than the Retailers' Occupation Tax Act or Use Tax Act.

Because the seller of the special order conveyor system is not a party to this letter ruling, we cannot provide a ruling on the seller's Service Occupation Tax or Use Tax liability. However, we can provide you a conditional ruling regarding COMPANY's Use Tax or Service Use Tax liability, if any, based upon the sellers activities. You stated in your letter that the seller's cost of goods sold represents less than 35% of its overall revenues from sales of service. You have also represented that the seller is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Based upon these representations, we believe that COMPANY incurs no Use Tax or Service Use Tax liability on the purchase of the special order conveyor system.

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules or in the factual representations recited in this ruling.

If you have further questions concerning this Private Letter ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Martha P. Mote
Associate Counsel

MPM:msk

¹ 35 ILCS 120/2

² 35 ILCS 105/3; 35 ILCS 105/3-10

³ 35 ILCS 1115/3 [sic]; 35 ILCS 115/3-10

⁴ 35 ILCS 105/3-10

⁵ 35 ILCS 115/2; 86 Ill. Adm. Code Sec. 140-201(a).

⁶ 86 Ill. Admin. Code Sec. 130.2115(b) and (c)

⁷ *Caterpillar Tractor Co. v. Department of Revenue* (Ill. Supreme Court, 1963).

⁸ 35 ILCS 115/3-10; 86 Ill. Adm. Code Sec. 140.105, 140.108, and 140.109.